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No. 95-2067

In the Supreme Court of the United States

OCTOBER TERM, 1995

EDWARD E. ROBINSON AND SANDRA ROBINSON,
PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTION PRESENTED

Whether the courts below correctly allocated the proceeds of a settlement agreement between "damages received * * * on account of personal injuries" that are excluded from gross income under Section 104(a)(2) of the Internal Revenue Code, 26 U.S.C. 104(a)(2), and damages for non-personal injuries that are not within this statutory exclusion.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-14a) is reported at 70 F.3d 34. The opinion of the Tax Court (Pet. App. 1b-34b) is reported at 102 T.C. 116.

JURISDICTION

The judgment of the court of appeals was entered on December 5, 1995. The petition for a writ of certiorari was filed on March 4, 1996. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Petitioners obtained a state court jury verdict against a bank for wrongful failure to release a lien.

The verdict included $6,000,000 for lost profits, $1,500,000 for mental anguish and $50,000,000 in punitive damages (Pet. App. 4a, 7b-8b). The bank filed a motion for a new trial. While that motion was pending, the parties conducted settlement negotiations. During these negotiations, petitioners' attorneys informed the bank that petitioners desired to allocate any settlement proceeds among their various damage claims in a manner that would minimize their tax liability. The bank's representatives stated that they had no objection to structuring a settlement to accomplish that goal. The bank's sole concern was to obtain a complete and final release from all possible claims arising from the matter (Pet. App. 4a, 8a, 13a, 8b-9b).

The parties thereafter entered into a final settlement agreement. Under that agreement, the bank paid petitioners $10,000,000 and released petitioners from a judgment of approximately $700,000. The parties prepared a stipulated judgment for entry by the district court that substituted the terms of the settlement for the jury verdict. The stipulated judgment stated that 95 percent of the settlement proceeds were allocated to mental anguish and 5 percent were allocated to lost profits (Pet. App. 4a, 9b-10b).

The parties presented the stipulated judgment to the judge at his home for his signature. The meeting at the judge's home started late in the evening and lasted no longer than one hour. Neither the final judgment nor the settlement agreement was discussed in detail. The form of judgment that the parties had prepared was signed and entered by the court at that time (Pet. App. 9b-10b).

After paying attorneys' fees and costs, petitioners received $4,935,152.43 of the settlement proceeds. Of that amount, petitioners reported only 5 percent, or $246,758, as income on their 1987 joint income tax return. They contended that the other 95 percent represented compensation for mental anguish and is excluded from income under Section 104(a)(2) of the Internal Revenue Code as "damages received * * * on account of personal injuries or sickness" (26 U.S.C. 104(a)(2)).

2. On audit, the Internal Revenue Service determined that 95 percent of the proceeds of the settlement was taxable income from non-personal injuries. Petitioners sought a redetermination of the resulting income tax deficiency in the Tax Court.

The Tax Court found that the allocation of the settlement proceeds contained in the stipulated state court judgment did not reflect the genuine nature of the damages that petitioners received. The court noted that petitioners had consciously allocated the settlement proceeds in a manner designed to minimize their tax liability, rather than to reflect the genuine nature of their claims. The court therefore reallocated the settlement proceeds based upon the award of damages entered by the jury in the state court suit. The fact that the jury verdict followed "a long and strenuous trial" indicated to the court that the verdict "had a direct bearing on the bank's settlement payment" (Pet. App. 24b). Petitioners had been advised by their counsel that the $50,000,000 punitive damage award was the result of a "runaway jury" and would most likely be vacated or reduced on appeal. The court found that "petitioners and bank both anticipated a significant reduction in the punitive damage award in the event of appeal, and agreed

to the terms of the settlement agreement with this in mind" (Pet. App. 24b-25b). The court therefore first allocated the settlement proceeds to the actual damages received, then to prejudgment interest, and finally the remainder to punitive damages (*ibid.*).

The court concluded that the amounts thus attributable to punitive damages, mental anguish and injury to credit reputation represent damages for personal injuries excluded from tax under Section 104(a)(2). The court held that the balance of the net payment to petitioners was includable in their gross income (Pet. App. 6a-7a).

3. The court of appeals upheld the Tax Court's allocation of the settlement proceeds. The court held that the allocation set forth in the stipulated state court judgment was contrived simply to avoid taxes and was not binding. The court of appeals agreed that the jury verdict was "the best indication of the worth of the Robinsons' claims" and therefore upheld the Tax Court's allocation of the settlement proceeds (Pet. App. 8a-9a).[1]

ARGUMENT

The decision of the court of appeals is correct and does not conflict with any decision of this Court or any other court of appeals. Further review is therefore not warranted.

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[1] On the government's appeal, the court further held (Pet. App. 7a-8a) that the punitive damages do not represent compensation for personal injuries within the scope of the exclusion from income provided by Section 104(a)(2). The court therefore reversed the Tax Court's determination that the punitive damages allocated from the proceeds of the settlement are excluded from tax. Petitioners have not sought further review of that ruling.

1. The proper characterization and allocation of the proceeds of a settlement for federal income tax purposes is an inherently factual inquiry that is reviewable for clear error. *Knuckles* v. *Commissioner*, 349 F.2d 610, 612 (10th Cir. 1965); *Agar* v. *Commissioner*, 290 F.2d 283, 283 (2d Cir. 1961). The allocation made by the courts below in this case is supported by the record and is not clearly erroneous.

The record reflects that the allocation of proceeds set forth in the stipulated state court judgment—which assigned 95 percent of the settlement proceeds to mental anguish—did not reflect a genuine evaluation of the nature and strength of petitioners' claims. Instead, it represented an accomodation by the bank of petitioners' acknowledged attempt to minimize their federal income tax liabilities.[2] Because the allocation contained in the stipulated judgment was not the result of an arm's-length or adversarial evaluation of the nature of the underlying claims, the Tax Court properly looked to the state court jury verdict to determine the nature of the damages actually reflected in the settlement agreement. The court concluded that the jury verdict, which followed "a long and strenuous trial," "had a direct bearing on the bank's settlement payment" (Pet. App. 24b). That conclusion, and the resulting allocation of the settlement proceeds in this case, is not clearly erroneous. Further review of this factual determination, con-

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[2] During the course of the negotiations of the settlement agreement, petitioners' attorney informed the bank that petitioners desired to allocate the proceeds in a manner that would reduce their income tax obligations. The bank's representatives, on their part, had no objection to wording the stipulated judgment in a manner that would assist petitioners' tax strategy (Pet. App. 8a, 13a, 8b-9b).

curred in by both courts below, is not warranted. See *Tiffany Fine Arts, Inc.* v. *United States*, 469 U.S. 310, 317-318 n.5 (1985).

2. Petitioners err in contending (Pet. 9-16) that this Court's decision in *United States* v. *Burke*, 504 U.S. 229 (1992), requires the Commissioner to accept for tax purposes the allocation of damages contained in the stipulated state court judgment. Neither *Burke* nor the subsequent decision in *Commissioner* v. *Schleier*, 115 S. Ct. 2159 (1995), addresses the question of the amount of deference owed to a state court stipulated judgment in allocating damages between personal and non-personal injuries. As petitioners note (Pet. 18), however, in *Commissioner* v. *Estate of Bosch*, 387 U.S. 456 (1967), this Court stated that state court judgments are to be given "proper regard" in determining the federal income tax characterization of items of income. The courts below properly applied the standard described by this Court in *Estate of Bosch*.

The court of appeals summarized the evidentiary basis for rejecting any reliance on the stipulated judgment in determining the character of the damages awarded to petitioners (Pet. App. 9a):

> The testimony of the attorneys who represented the Robinsons in their suit against the bank supports the Tax Court's finding that the bank allowed the Robinsons to allocate the settlement proceeds in any manner they wished. * * * The circumstances surrounding the state court judge's entry of judgment also support the trial court's findings. The parties presented the final judgment to the trial judge at his home in the evening. The meeting at the judge's home lasted

> no longer than one hour, and neither the final judgment nor the settlement agreement were discussed in detail during that meeting. Therefore, the Tax Court did not err in failing to give proper regard to the state court judg[]ment's allocation of settlement proceeds.

As the Tax Court noted, the allocation of damages set forth in the stipulated state court judgment is entitled to no weight in determining federal tax consequences because that allocation "was uncontested, nonadversarial, and entirely tax-motivated" (Pet. App. 17b).

Nothing in *Estate of Bosch* supports the contention that an allocation contrived to avoid federal income tax consequences in a stipulated, non-adversary state court judgment is entitled to conclusive effect. The Court stated in *Bosch* that decisions of state trial courts are not binding in federal tax matters because only the highest court of a State can authoritatively interpret that State's law. 387 U.S. at 465. While stating that the decisions of state trial courts are nonetheless entitled to "proper regard," the Court pointed out that Congress intended such limited deference to apply only to decisions entered by a state court "in a bona fide adversary proceeding." *Id.* at 464. In *Bosch*, the Commissioner was not a party to the state proceedings, which were brought "for the purpose of directly affecting federal estate tax liability." *Id.* at 463. The Court held that the state trial court decrees in that case were therefore *not* conclusive for federal tax purposes. *Id.* at 466.

The reasoning applied by this Court in *Estate of Bosch* directly supports the decision in this case. The state court's approval of the allocation of the settle-

ment proceeds to mental anguish and lost profits is not controlling for federal tax purposes because the merits of that allocation were not contested or adjudicated in a bona fide adversary proceeding. The "proper regard" required under *Bosch* does not include the acceptance of a stipulated judgment that was negotiated, drafted and entered for the purpose of avoiding federal tax liabilities. 387 U.S. at 463. See also *id.* at 471 (Douglas, J., dissenting) ("[a] federal court might not be bound by a consent decree, for it does not purport to be a declaration of state law; it may be merely a judicial stamp placed upon the parties' contractual settlement"); *Brown* v. *United States*, 890 F.2d 1329, 1341-1342 (5th Cir. 1989) (under *Bosch*, nonadversarial state trial court decree that "had no practical consequences apart from this federal tax controversy" was not binding for federal tax purposes); *Bath* v. *United States*, 480 F.2d 289, 290-292 (5th Cir. 1973) ("in the light of the absence of true adversary litigation, [and] the total waiver of substantial defenses," probate court's holding in will contest that heir received share of estate as compensation for services was not controlling for federal tax purposes).

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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